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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 280

THE LOCKE MACHINE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 128-141) is not reported. The opinion of the Court of Appeals (R. 153-155) is reported in 168 F. 2d 21.

JURISDICTION

The judgment of the Court of Appeals was entered May 17, 1948. (R. 151.) The taxpayer's petition for rehearing was denied June 21, 1948. (R. 171.) The petition for a writ of certiorari was filed September 16, 1948. The jurisdiction

of this Court is invoked under 28 U. S. C.

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's decision that a portion of the amounts claimed by taxpayer corporation under Section 23(a)(1)(A) of the Internal Revenue Code as deductions for compensation paid to its four executives-stockholders in 1941 was unreasonable.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, infra, pp. 16-19.

STATEMENT

The facts as stipulated (R. 14-34) and found by the Tax Court (R. 128-133) may be summarized as follows:

Taxpayer corporation manufactures and sells screw machine products and coaster brakes. Until 1941 (the taxable year) it sold its brakes through a brokerage company; early in that year Sears Roebuck Company took over the business of the brokerage company and placed an order with taxpayer for all the brakes it could manufacture. (R. 129-130, 137.) Taxpayer's sales, operating profits, and percent of dividends to capital stock from 1938 to 1941, inclusive, were as follows (R. 129):

	1938	1939	1940	1941
Net Sales	$209,096.89	$384,557.14	$332,156.17	$714,963.48
Operating Profit	$ 12,370.46	$ 60,033.55	$ 45,529.85	$176,796.31
Per Cent of Dividends to Capital Stock	6%	30%	10%	25%

E. H. Baker, Jr., vice president and general manager of taxpayer, had been associated with the company since 1919, during which time the company had steadily prospered. J. E. Tomer, secretary and assistant treasurer, had been associated with taxpayer since 1922. E. C. Sinclair, plant superintendent, had been with the company since 1928. Otto Gammel, office manager, first entered taxpayer's employ in 1934 as an accountant. At the beginning of 1941 Baker and his mother respectively owned 330 and 252 shares (a total of 582) of the 675 shares of taxpayer's stock; his mother died in March of that year and bequeathed all her stock to him. Tomer, Sinclair and Gammel each owned 10 shares of taxpayer's stock at the beginning of 1941, and 27 shares at the end of the year. Tomer and Sinclair were also directors of taxpayer. (R. 130-131.)

In 1927 taxpayer adopted a plan of compensating certain of its executive employees by payment of a bonus in addition to regular salaries. The bonus consisted of a percentage of taxpayer's profits, after setting aside an amount equal to 10 percent of the capital stock. Prior to 1941 the bonus amounted to 27 percent, allocated 10 percent to Baker, 9 percent to Sinclair and 8 percent to Tomer. At the beginning of 1941 Gammel threatened to leave taxpayer's employ unless he participated in bonus payments. In April of 1941 the bonus fund was accordingly raised from 27

percent to 29 percent, of which 9 percent was allocated to Baker, 8 percent to Sinclair, 7 percent to Tomer, and 5 percent to Gammel. At the same time the basic salaries of these four executives were raised as follows: Baker, from $9,600 to $15,000 (a $5,400 increase); Sinclair, from $4,320 to $4,920 (a $600 increase); Tomer, from $3,600 to $4,080 (a $480 increase); and Gammel, from $2,686.60 to $2,760 (a $73.40 increase). (R. 130, 131-132.) The fixed salary and bonus payments to these four individuals for the years 1938 to 1941, inclusive, were as follows (R. 130):

	1938	1939	1940	1941
E. H. Baker, Jr.				
Salary	$9,600.00	$ 9,600.00	$ 9,600.00	$15,000.00
Bonus	390.73	4,648.65	3,392.71	14,038.84
Total	$9,990.73	$14,248.65	$12,992.71	$29,038.84
J. E. Tomer				
Salary	$3,600.00	$ 3,600.00	$ 3,600.00	$ 4,080.00
Bonus	312.58	3,718.91	2,714.17	10,919.09
Total	$3,912.58	$ 7,318.91	$ 6,314.17	$14,999.09
E. C. Sinclair				
Salary	$4,320.00	$ 4,320.00	$ 4,320.00	$ 4,920.00
Bonus	351.66	4,183.78	3,053.44	12,478.97
Total	$4,671.66	$ 8,503.78	$ 7,373.44	$17,398.97
O. Gammel				
Salary	$2,242.60	$ 2,449.62	$ 2,686.60	$ 2,760.00
Bonus	.....	.....	.....	7,799.35
Total	$2,242.60	$ 2,449.62	$ 2,686.60	$10,559.35

There was no increase in the services or responsibilities of Baker and Tomer during 1941. Baker, who received the largest salary increase, spent three months of the year in California. There was some increase in the services and duties of Sinclair and Gammel, but this was far out of proportion

to the increase in their salaries. (R. 135, 137, 138-139.) Taxpayer offered no testimony whatever of salaries paid for like services by other enterprises engaged in similar businesses. (R. 137.) The increase in salaries for 1941 was based almost wholly upon taxpayer's increased profits resulting from the war demand for its products. In April of 1941, when the increases were voted, taxpayer anticipated large and unusual profits for that year. (R. 137.)

Taxpayer deducted from its 1941 gross income a total of $71,996.25 as compensation paid to its four executive employees (R. 128), as compared with a total of $29,366.92 for the preceding year (R. 130), and the Commissioner allowed a total of $36,500 as reasonable (R. 129). For Baker taxpayer deducted $29,038.84 in 1941 (as compared with $12,992.71 for 1940), and the Commissioner allowed $16,000. For Tomer it deducted $14,999.09 in 1941 (as compared with $6,314.17 for 1940), and the Commissioner allowed $8,000. For Sinclair it deducted $17,398.97 in 1941 (as compared with $7,373.44 for 1940), and the Commissioner allowed $9,000. For Gammel it deducted $10,559.35 in 1941 (as compared with $2,686.60 for 1940), and the Commissioner allowed $3,500. (R. 129, 130.) The Tax Court sustained the Commissioner's determination as to Baker and Tomer, but overruled his determination in part by increasing the allowance for Sinclair by $1,000 and

for Gammel by $4,000, resulting in a total allowance by the Tax Court of $41,500. (R. 138-139.) It concluded that taxpayer had failed to prove the reasonableness of payments larger than those amounts. Taxpayer appealed from that portion of the Tax Court's decision which was adverse to it, and the Court of Appeals affirmed. (R. 153-155.)

ARGUMENT

1. Section 23(a)(1)(A) of the Internal Revenue Code (Appendix, *infra*), authorizes the deduction from gross income of "ordinary and necessary" business expenses "paid or incurred" during the taxable year, "including a reasonable allowance for salaries or other compensation", traveling expenses, and rental payments. Section 19.23(a)-6 of Treasury Regulations 103 under the Code (Appendix, *infra*), which is the same as those under prior Acts,[1] provides *inter alia* that "The test of deductibility in the case of compensation payments is whether they are reasonable". Section 19.23(a)-8 of the Regulations (Appendix, *infra*), which is also the same as those under prior Acts,[2] provides that "bonuses" to employees are

[1] Section 19.23(a)-6 of Regulations 103 under the Code is the same as Article 23(a)-6 of Regulations 101 (1938 Act), Regulations 94 (1936 Act), and Regulations 86 (1934 Act). It is substantially the same as Article 126 of Regulations 77 (1932 Act) and Regulations 74 (1928 Act), Article 106 of Regulations 69 (1926 Act) and Regulations 65 (1924 Act), and Article 105 of Regulations 62 (1921 Act), and Regulations 45 (1918 Act).

[2] Section 19.23(a)-8 of Regulations 103 under the Code is the same as Article 23(a)-8 of Regulations 101 (1938 Act),

deductible "provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered." Since the statutory provisions to which these Regulations are addressed have been reenacted in the successive Revenue Acts since 1918,[3] the Regulations must be "deemed to possess implied legislative approval and to have the effect of law". *Commissioner* v. *Flowers*, 326 U. S. 465, 469. See also *Boehm* v. *Commissioner*, 326 U. S. 287, rehearing denied, 326 U. S. 811; *Helvering* v. *Winmill*, 305 U. S. 79.

In harmony with the statutes and the long-standing Regulations, the courts, in a multitude of cases involving the question here presented, have uniformly held that (1) to qualify for deduction under Section 23(a) a salary payment must be reasonable in amount; (2) how much is reasonable presents a question of fact in each case; (3) the Commissioner's determination is presumptively correct, the taxpayer having the burden of proving the reasonableness of the

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Regulations 94 (1936 Act), and Regulations 86 (1934 Act); Article 128 of Regulations 77 (1932 Act) and Regulations 74 (1928 Act); Article 108 of Regulations 69 (1926 Act) and Regulations 65 (1924 Act). It is substantially the same as Article 107 of Regulations 62 (1921 Act), and Regulations 45 (1918 Act), and Article 138 of Regulations 33 (1916 Act).

[3] Code Section 23(a)(1)(A), with the exception of the caption, is the same as Section 23(a)(1) of the 1938 Act; Section 23(a) of the 1936, 1934, 1932 and 1928 Acts; and Section 214(a)(1) of the 1926, 1924, and 1921 Acts. Except for the traveling expense clause (inserted in the 1921 Act), it is also the same as Section 214(a)(1) of the 1918 Act.

claimed amount; and (4) the Tax Court's finding (upon review of the Commissioner's determination) of the amount constituting reasonable compensation is conclusive on appeal if supported by substantial evidence, or if the taxpayer's evidence is too weak to carry the burden resting on it. And in each instance in which the taxpayer has sought certiorari, this Court has denied further review.[4] Nothing has occurred since the denial of certiorari in those cases which calls for further review of this case.

2. Taxpayer does not and cannot assert conflict with any decisions of this Court or any other court. Relying upon Treasury Regulations which have no relevancy here,[5] it contends (Pet. 5-7, Br.

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[4] *Long Island Drug Co.* v. *Commissioner*, 111 F. 2d 593 (C.C.A. 2d), certiorari denied, 311 U. S. 680; *L. & C. Mayers Co.* v. *Commissioner*, 131 F. 2d 309 (C.C.A. 2d), certiorari denied, 318 U. S. 773; *Gem Jewelry Co.* v. *Commissioner*, 165 F. 2d 991 (C.C.A. 5th), certiorari denied, 334 U. S. 846; *Glenshaw Glass Co.* v. *Commissioner*, decided October 15, 1946 (1946 P-H T. C. Memorandum Decisions, ¶ 46,245), affirmed (C.C.A. 3d) October 21, 1947, certiorari denied, 333 U. S. 842; *L. E. Pinkham Med. Co.* v. *Commissioner*, 128 F. 2d 986 (C.C.A. 1st), certiorari denied, 317 U. S. 675; *Forest Products Chemical Co.* v. *Commissioner*, 27 B.T.A. 638, affirmed (C.C.A 6th) December 18, 1934, certiorari denied, 294 U. S. 726; *Smith* v. *Russell*, 76 F. 2d 91 (C.C.A. 8th), certiorari denied, 296 U. S. 614; *Kennington* v. *Donald*, 50 F. 2d 894 (C.C.A. 5th), certiorari denied, 284 U. S. 664; *Field & Start, Inc.* v. *Commissioner*, 17 B.T.A. 1206, affirmed, 44 F. 2d 1014 (C.C.A. 2d), certiorari denied, 283 U. S. 826.

[5] Regulations 41, relied upon by taxpayer (Br. 14), pertain solely to the excess profits tax imposed by the Revenue Act of 1917, c. 63, 40 Stat. 300. T. D. 2696, April 10, 1918 (20 Treasury Decisions 330), quoted in part by taxpayer (Br. 13, fn. 2) was superseded by Article 105 of Regulations 45 (1920 ed.) under the Revenue Act of 1918, which is the genesis of Section 19.23(a)-6 of Regulations 103 under the Code.

12-18) that the test of reasonableness prescribed by Section 23(a) applies to unpaid compensation, not to compensation paid in good faith; in short, that the taxpayer is the sole judge of the deductibility of its salary payments. As the court below observed (R. 154), the contention runs counter to the language of the statute, the long-standing implementing Regulations, and the applicable decisions.

The portion of Section 23(a) which authorizes the deduction of "a reasonable allowance for salaries or other compensation"—like the ensuing portions authorizing the deduction of travel and rent expenses—represents but "one of the specific examples given by Congress in that section of 'ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business' ". *Commissioner* v. *Flowers, supra,* p. 469; cf. *Helvering* v. *Morgan's, Inc.,* 293 U. S. 121. The phrase "paid or incurred during the taxable year", appearing in the omnibus portion of the section, relates to when (i. e., which taxable year) the business expense is deductible, not to whether it is deductible.[6] Though "paid or incurred", the expense must still be "ordinary" to be deductible. Even under the 1916 Act—before the compensation clause was added to the section—this Court held that "extravagant" compensa-

[6] Since taxpayer filed its returns on the accrual basis (R. 128) its allowable business expenses were deductible in the taxable year "incurred". See Code Sections 43, 48(c), (26 U.S.C. 1946 ed., Secs. 43, 48).

tion payments to corporate officers "cannot be regarded as 'ordinary and necessary expenses' ", and do not qualify for deduction "merely because the payments are made in accordance with an agreement between the corporation and its officers" and pursuant to an established bonus plan. *Botany Mills* v. *United States,* 278 U. S. 282, 292. See also *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C.C.A. 2d), certiorari denied, 311 U. S. 680. As taxpayer acknowledges (Br. 15-16), no change in allowable business expense deductions was intended by the insertion in the 1918 Act of the inclusionary clause relating to compensation. Certainly there is nothing in the legislative history of Section 23(a) to which taxpayer refers, or which we have discovered, which even remotely suggests that, merely because compensation is "paid or incurred" in good faith, it need not be "reasonable" to be allowable.[6a] This class of business expense is no more allowable simply because it is paid or incurred than any other.[7]

[6a] The note of Dean Griswold, in 56 Harv. L. Rev. 997 (1943), upon which taxpayer relies (Br. 16), states (p. 997) that the clause has "no legislative history" and "went through Congress without any specific consideration."

[7] Significantly, the traveling expense clause of Section 23(a) does not contain the word "reasonable", yet this Court has held that "The expense must be a reasonable and necessary traveling expense" to qualify for deduction under that section. *Commissioner* v. *Flowers, supra,* p. 470. And even though the rent clause of the section does not contain the word "reasonable", it has been held that "rentals or other payments for the use of property which are excessive in amount, taking into consideration all the facts of the particular case, do not constitute ordinary and necessary business expenses". *Limer-*

"The mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under Section 23(a)." *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590, 594. Similarly, the fact that an expense was "paid" in good faith —and even a "necessary" one—is not determinative *per se* of its deductibility. *Welch* v. *Helvering,* 290 U. S. 111.

To subscribe to taxpayer's novel construction of Section 23(a) would in effect erase the words "ordinary" and "reasonable" from the statute, disregard the long-standing Treasury Regulations which have received implied legislative approval, and upset two decades of administrative practice and court decisions. There would be no ceiling on salary deductions or, for that matter, on any other kind of business expense deduction claimed under Section 23(a); the taxpayer himself would become the sole judge of deductibility for tax purposes. It is inconceivable that Congress so intended. The test of deductibility under Section 23 is an objective rather than a subjective one. *Commissioner* v. *Flowers, supra; Welch* v. *Helvering, supra; Boehm* v. *Commissioner, supra.* Taxpayer is no more the exclusive and final judge of what is deductible from gross income under Section 23

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icks, Inc. v. *Commissioner,* 165 F. 2d 483, 484 (C.C.A. 5th). *A fortiori* compensation payments, which Congress has expressly stated must be "reasonable" to be "allowable", do not qualify for deduction unless they are reasonable in amount.

than, for example, of what is includible in gross income under Section 22. Indeed, the elementary rule that deductions are matters of legislative grace and that the taxpayer has the burden of clearly proving the Commissioner's determination, presumptively correct, to be wrong (*Welch* v. *Helvering, supra; Interstate Transit Lines* v. *Commissioner, supra; Deputy* v. *du Pont,* 308 U. S. 488), would become well-nigh meaningless if, as taxpayer urges, the Commissioner and the Tax Court are without power to question the reasonableness of a claimed salary deduction.

3. The record unquestionably warrants the Tax Court's determination (R. 138) that taxpayer failed to sustain the burden of proving the reasonableness of the claimed salary deductions. The compensation paid by taxpayer to its four executives for the taxable year (1941) was more than double the amount paid for the preceding year (R. 29, 130), and represented over 60 percent of its net profits before taxes (R. 33, 129).[8] The increase resulted partly from an increase in fixed salaries, and partly from payment of a bonus measured by a percentage of taxpayer's profits. (R. 132.) And the chief beneficiary of the increase was taxpayer's controlling stockholder,

[8] The claimed deductions for 1941 totaled $71,996.25, as compared with a total of $29,366.92 for 1940. (R. 29, 130.) Taxpayer's operating profit for 1941 amounted to $176,796.31, and its net profits before federal taxes amounted to $114,380.84. (R. 33, 129.)

Baker. (R. 131.) The Tax Court found (R. 135, 137, 138-139), and it is undisputed, that the services performed by two of the executives (Baker and Tomer) were no different in 1941 than in 1940; and while there was some enlargement of the responsibilities of the other two (Sinclair and Gammel), the Tax Court took this into account by raising the amount which the Commissioner had allowed for them. Moreover, the increase in fixed salaries was not awarded before the services were rendered, but in April of the taxable year (R. 132), after taxpayer obtained an order for all the coaster brakes it could produce and anticipated an unusually prosperous year (R. 130, 137). See Section 19.23(a)-6(2) of Regulations 103. What is more, the compensation was not fixed by an arm's-length bargain; the four recipients owned all but a few shares of taxpayer's stock, and two of them were also directors (R. 130-131), an important factor to be considered. *Crescent Bed Co.* v. *Commissioner,* 133 F. 2d 424 (C.C.A. 5th); Section 19.23(a)-6(2) of Regulations 103. Finally, taxpayer offered no testimony which would afford a comparison of the compensation paid with that paid "for like services by like enterprises under like circumstances". Section 19.23(a)-6(3) of Regulations 103. This was a serious deficiency in its proof. *Clinton Co.* v. *Commissioner,* 159 F. 2d 102 (C.C.A. 7th); *In re Rae's Estate,* 147 F. 2d 204 (C.C.A. 3d); *L. & C. Mayers Co.* v. *Commis-*

sioner, 131 F. 2d 309 (C.C.A. 2d); *Gem Jewelry Co.* v. *Commissioner,* 165 F. 2d 991 (C.C.A. 5th). In short, as the Tax Court noted (R. 137), the increased compensation was "based almost wholly upon the increased profits" of taxpayer. This factor, while relevant, is by no means conclusive of the reasonableness of the amount paid (*Clinton Co.* v. *Commissioner, supra*), especially where, as here (R. 134-137), the increase in profits was not attributable to increased services but to the war demand for taxpayer's products (*Miller Mfg. Co.* v. *Commissioner,* 149 F. 2d 421 (C.C.A. 4th)). Under the circumstances, the Tax Court was fully justified in concluding that taxpayer had failed to sustain the burden of proving that $71,996 compensation deducted from its 1941 gross income (as compared with $29,366 deducted in 1940 (R. 130)) represented reasonable compensation.

Taxpayer's contention (Pet. 7-8, Br. 19-20) that the Tax Court reached its decision by considering only the source of taxpayer's earnings and the Government's war-time need for revenues, is patently unfounded. As the affirming opinion below points out (R. 154-155), the contention rests upon taxpayer's self-serving interpretation of selected portions of the Tax Court's opinion, and disregards the plain tenor of the opinion as a whole. The undisputed evidentiary facts fully support the Tax Court's determination of the "reasonable" amounts deductible, and the court

below properly refused to substitute its own inference for that of the Tax Court. If there is any question which calls for application of the familiar rule that it is the Tax Court's function to find the facts and draw inferences from them, it is the recurrent one of what constitutes a "reasonable allowance" for compensation under Section 23(a).

CONCLUSION

The decision below is correct. The question presented is purely one of fact. There is no conflict, and no occasion for further review. The petition should therefore be denied.

Respectfully submitted,

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OCTOBER, 1948.

APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * *

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23(a)-6. *Compensation for personal services.*—Among the ordinary and necessary

expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

* * * * *

SEC. 19.23(a)-8. *Bonuses to employees.*— Bonuses to employees will constitute allowable deductions from gross income when such pay-

ments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

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